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No. 10-1049

In the Supreme Court of the United States

JOHN LARSON AND ROBERT PFAFF,

Petitioners,

v.

THE UNITED STATES OF AMERICA,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITIONERS' REPLY BRIEF

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ARGUMENT

The opposition confirms why this Court's intervention is urgently needed. The government steadfastly ignores, but cannot deny, the great national significance of this case—"the largest criminal tax case in American history," *Stein v. KPMG, LLP*, 486 F.3d 753, 756 (2d Cir. 2007), which was built on a "fairly novel theory of criminal liability," *United States v. Stein*, 541 F.3d 130, 157 (2d Cir. 2008), and on the most infamous abuse of prosecutorial power in recent memory. The opposition forthrightly embraces the Second Circuit's misguided and dangerous holding that a defendant can "willfully" violate tax obligations even when those obligations are ambiguous and the defendant's conduct was objectively reasonable. The government's efforts to minimize the square circuit split on that issue—which the United States previously has asked this Court to resolve—are half-hearted and unpersuasive. And the government does not even attempt to deny that its boundless interpretation of 26 U.S.C. §7201 destroys Congress's carefully gradated system of tax offenses.

1. The government endorses the Second Circuit's reasoning and contends that any person "who intentionally attempts to exploit a supposed ambiguity in the tax laws" is a felon—even if the law *was* ambiguous and his interpretation was objectively reasonable—if a jury finds that he subjectively did not believe his position would or should ultimately prevail. Opp.11. The government argues that the five Justices who concluded otherwise in *James v. United States*,

366 U.S. 213 (1961), were wrong,[1] and that this Court's recent unanimous contrary holding in *Safeco Insurance Co v. Burr*, 551 U.S. 47, 70 n.20 (2007), must be confined (bizarrely) to the civil context.

The government's candor about the radical theory underlying this prosecution crystallizes the issues for this Court and demonstrates why review is necessary. As a statutory matter, the government's position is obviously untenable. Taxpayers are immune from all civil penalties when there is, objectively, "substantial authority" supporting their positions—regardless of state of mind. Treas. Reg. §1.6662-4(d)(2). The only court that has ever considered BLIPS in a civil context concluded that no penalties could be imposed because of that rule. Pet.13. So the government's position is that Congress intended to immunize taxpayers from even modest civil penalties when their conduct is consistent with an objectively reasonable understanding of the law—but intended to send those same taxpayers (and anyone else, like petitioners, who has *any* connection to the transaction) to jail for the same conduct. And the government thinks that citizens are given fair warning of that absurd and counter-intuitive rule, notwithstanding the rule of lenity, solely by the word "willfully"—which the government concedes can have many meanings. Opp.18.

Counsel are aware of no Supreme Court precedent for punishing violations of objectively unclear legal

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[1] Justices Black and Douglas agreed with the plurality that the defendants were entitled to acquittal because of the ambiguity. *See id.* at 224 (Black, J., concurring in part and dissenting in part); *United States v. Critzer*, 498 F.2d 1160, 1163 n.5 (4th Cir. 1974).

duties. The whole purpose of the rule of lenity is to make such prosecutions impossible.

The government concedes that its position is inconsistent with *Safeco*, but contends that *Safeco*'s unanimous holding should be limited to cases involving *civil* penalties imposed under a recklessness standard—which, the government says, is "objective," whereas willfulness is "'the voluntary, intentional violation of a known legal duty.'" Opp.18-19 (quoting *Cheek v. United States*, 498 U.S. 192, 201 (1991)). But as Judge Wilkinson explained in *United States v. Mallas*, a "'voluntary intentional violation of a known duty,' requires that the duty involved must be *knowable*." 762 F.2d 361, 363 (4th Cir. 1985) (emphasis added). This Court has held in other contexts that that a defendant cannot "fairly be said to 'know' that the law forbade conduct" where the conduct was "objective[ly] reasonable[] ... as measured by reference to clearly established law." *Harlow v. Fitzgerald*, 457 U.S. 800, 818-19 (1982).

This Court held in *Cheek* that the unusual vagueness of the tax laws required a new subjective good-faith defense even for objectively *un*reasonable conduct, but gave no hint that it intended thereby to criminalize objectively *reasonable* conduct for the first time. *Safeco* certainly provides no support for the government's spurious distinction. This Court reasoned that "Congress could not have intended" penalties for willfulness "for those who followed an interpretation that could reasonably have found support in the courts." 551 U.S. at 70 n.20. That inference is vastly stronger here—where severe *criminal* penalties are at issue and the "substantial

authority" defense expressly precludes even a modest civil penalty.

2. The government concedes that the Second, Fifth, and Sixth Circuits have embraced its extreme position. Opp.10. Its efforts to distinguish the cases on the other side of the split are unpersuasive.

a. The government asserts that it somehow was "clear" that the defendant in *United States v. Critzer* subjectively believed that she owed no tax. The Fourth Circuit's actual holding was that "defendant's actual intent is irrelevant." 498 F.2d 1160, 1162 (4th Cir. 1974). And any ambiguity in *Critzer* is dispelled by *Mallas*.

b. The government says that in *United States v. Heller*, 830 F.2d 150 (11th Cir. 1987), the court "proceeded on the assumption that the defendant potentially had acted in good-faith reliance on legal authority." Opp.13. Not so. *Heller* held (citing *Critzer* and *James*) that the "requisite element of intent could not be proved when the law was uncertain or cast in doubt by prior court decisions," and that a prior case supportive of the taxpayer's position "was sufficient, *as a matter of law*, to make it inappropriate to impose criminal liability for following the case-closed method" of accounting. 830 F.2d at 154-55 (emphasis added). The court remanded for a new trial under instructions requiring acquittal if the defendant used that method. The Eleventh Circuit did not suggest that the defendant had to know about the prior case, or that he might be guilty if he subjectively believed that the case-closed method was unlawful.

c. The government acknowledges that *Mallas*, *Dahlstrom*, and *United States v. Harris*, 942 F.2d 1125 (7th Cir. 1991), hold that "a defendant does not act

willfully when the underlying tax law is objectively unclear." Opp.13. The government says those cases "also held" that conviction would violate due process, and argues that the split is "more apparent than real" because petitioners have not argued that the economic substance doctrine is unconstitutionally vague. Opp.15.

The holdings of these cases are clearly statutory, not constitutional. *Mallas*, 762 F.2d at 363; *see also, e.g*, *Harris*, 942 F.2d at 1131-32 & n.6. The government certainly understood *Dahlstrom* that way when it filed a petition for certiorari telling this Court that the Ninth Circuit's reasoning "squarely conflicts with [*United States v.*] *Ingredient Technology Corp.*[, 698 F.2d 88 (2d Cir. 1983)]." *See* U.S. Pet. for Cert., No. 83-1297, *United States v. Dahlstrom* ("U.S. *Dahlstrom* Pet."), at 15; *see also id.* at 11-12 (arguing that willfulness is solely "a question of subjective intent ..., not the objective certainty or uncertainty of the law").

Contrary to the government's contention (Opp.14), subsequent Ninth Circuit cases have not renounced *Dahlstrom*'s statutory holding. The most recent decision holds that "[t]he element of willfulness cannot obtain in a criminal tax evasion case unless 'the law clearly prohibited the conduct alleged in the indictment.'" *United States v. George*, 420 F.3d 991, 995 (9th Cir. 2005) (citing *James*; other citations omitted). And *United States v. Solomon* read *Dahlstrom* as holding that "the 'unsettled legality' of the tax shelter scheme denied 'fair notice' under the fifth amendment *and made it impossible for the defendants to have a specific intent to 'willfully' violate the federal statutes*." 825 F.2d 1292, 1297 (9th Cir. 1987) (emphasis added).

The Fourth, Seventh, and Ninth Circuits' interpretation of "willfully" was informed by fair warning concerns. Petitioners similarly have always argued that the doctrine of constitutional doubt supports their interpretation. *E.g.*, Pet.15-16; Larson CA2 Br.17, 37, 56. But none of the cases suggests that the objective ambiguity that defeats statutory willfulness is coextensive with due process vagueness doctrine. The government's position is that a jury finding of subjective scienter would *cure* any due process problem, so its implication that alternative due process holdings could ameliorate or reconcile the circuit split is disingenuous. *See* U.S. *Dahlstrom* Pet. 11-12 & n.10. And the bottom line is that these three circuits reverse convictions when tax obligations are objectively unclear, and the courts on the other side of the split do not. The Second Circuit's cursory due process analysis demonstrates that constitutional vagueness doctrine does not bridge this gap. As the government concedes, the Fourth Circuit held in *Mallas* that tax defendants are entitled to acquittal if existing regulations and case law "did not clearly resolve" the issue and defendant's position was "plausible." Opp.13. That is clearly true here. The Second Circuit's opinion effectively concedes that the law was unsettled, and merely concludes (unpersuasively) that prior precedent did not quite foreclose *the government's* interpretation. Pet.26-27.

In any event, petitioners *have* argued that the economic substance doctrine is "notoriously vague," Pet.21, and, as applied here, violates due process. *E.g.*, Pfaff CA2 Br.28-29, 38-40; Larson CA2 Br.37-38; CA2 App.1854-56, 2439-43. Petitioners framed their argument primarily in statutory terms because that is

what the leading cases do, and because of this Court's preference for interpreting statutes narrowly to avoid difficult constitutional questions. *See* Pet.15-16 ("[T]here is no reason to reach difficult constitutional questions that can be avoided so easily on statutory grounds."); *Skilling v. United States*, 130 S. Ct. 2896, 2927-28 (2010). But the Second Circuit actually resolved the constitutional question, App.6a; Opp.8 (acknowledging same), and this Court certainly could reach that issue if it became important.

3. a. The government suggests that "the parameters of the economic substance doctrine were not objectively unknowable," citing carefully selected case law and the BLIPS opinion letters. Opp.15-17. The petition acknowledged that civil cases in other circuits had used a "reasonable possibility of profit" test. That is why the opinion letters addressed it. But the petition demonstrated that:

- the doctrine was and is deeply unsettled and unpredictable nationwide, and that many precedents instead analyzed whether a transaction involved *any* possibility of profit, market risk, or economic effects;
- the IRS conceded, in a formal report to Congress the very summer that KPMG was debating BLIPS, that the case law was "conflicting" and "incoherent" and that "no economic effects" was the "most prominent" standard nationwide;
- the *Second Circuit* case law prior to the charged conduct consistently used a "no economic effects" or "no market risk" standard;

- the "reasonable-possibility-of-profit" test charged here is inconsistent with this Court's actual holding in *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); and
- the only court that has analyzed BLIPS in a civil context held that no civil penalties could be imposed because the taxpayers had objectively "substantial authority" for their position.

Pet.21-27. The government tellingly has *no* response to any of those points.

b. The opposition suggests that it is unclear how "no possibility of profit," "no market risk," and "no practical economic effects" are the same test, and how any of them differs from the "reasonable-possibility-of-profit" instruction used here.[2] The first three all capture the classic form of the economic substance doctrine, which disregards transactions that were essentially just illusory paper-shuffling that left the taxpayer's economic interests unchanged—such as the 1990s cases involving perfectly offsetting options straddles, or cases involving supposed contingencies that were actually within the taxpayer's control. That form of the doctrine is the only one supported by this Court's cases and the prior Second Circuit cases, and the only one that draws lines that are clear, objective, and predictable enough for criminal enforcement.

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[2] The government wrongly suggests that petitioners endorsed that test, Opp 16, but has not argued waiver (here or below). Though an early joint defense filing referenced that test, petitioners argued consistently that a "no-market-risk" or "no-possibility-of-profit" standard must be applied. Pet.8-9.

Petitioners would have been entitled to acquittal under any of those tests. The BLIPS currency forward contracts were real, and exposed the taxpayers to market risks and opportunities driven by geopolitical contingencies outside their control. If things had gotten worse in Argentina just a little faster, these investors would have made huge profits. The government says that "the Hong Kong dollar and Argentine peso were then relatively stable." Opp.6. But it cannot and does not deny (and therefore has conceded, *see* Sup.Ct.R. 15.2) that a devaluation was possible, that the BLIPS investors would have made very substantial profits if it happened, that the banks involved with BLIPS hedged these risks, and that Argentina's currency and economy did in fact collapse in dramatic fashion little more than a year later. Pet.2-3, 7-8. Regardless, for the willfulness issue all that matters is that application of the economic substance doctrine was *at least* ambiguous and debatable (even under the "reasonable-possibility-of-profit" test). This case therefore is a perfect vehicle to resolve the circuit split—and also to straighten out economic substance law, if this Court were so inclined.

c. The government attempts to cloud the issues presented with other arguments that it strategically abandoned below and that are now irrelevant. *See* Pet.22 n.4. It tries, for example, to suggest that these transactions were shams because most were terminated after 60 days, because the "premium" aspect of the loans was somehow illusory, or because the loan proceeds were never in the taxpayer's control. Opp.2-6. But this jury was instructed that the *only* issue was whether "there was no reasonable possibility that the transaction," considered "as a whole," "would

result in a profit." App.85a, 88a-90a; U.S. CA2 Br.129 (conceding same). The government cannot defend convictions on theories never submitted to the jury. And (giving maximum deference to the jury's verdict) the petition *accepted* the government's arguments that BLIPS should be evaluated as a 60-day transaction.

4. On the separate §7201 question, the government does not deny that the Second Circuit's limitless interpretation collapses all the different gradated tax penalties into §7201 and renders other provisions like §7206(2)—which has been used instead of §7201 in every prior tax-shelter promoter prosecution—entirely superfluous. Pet.27-28. Contrary to the government's argument, the jury did not "conclude[] that [petitioners'] conduct was in no way remote from [the BLIPS clients'] tax evasion." Opp.20. The instructions did not ask the jury to make *any* findings concerning remoteness or proximate causation (over petitioners' objection). CA2 App.2617/4496-97.

The government cites no case affirming a §7201 conviction of anyone this remote from the tax returns. It cites two aiding and abetting cases (Opp.20), but the government's expansive theory of 18 U.S.C. §2 liability here just collapses the gradated structure of tax crimes via a slightly different analytical route. Even if accepted, that alternative theory cannot save these convictions. The §2 instructions required a finding that petitioners were a "substantial" cause of the tax underpayments. Opp.21-22. A reasonable jury easily could have concluded otherwise, given how remote petitioners were from the returns and all of the independent intervening causes. The taxpayers had independent tax advisors (Pfaff CA2 Br.16-17), and independently elected to file returns claiming the

BLIPS losses—in some cases even after the IRS issued negative guidance about the transaction and KPMG warned them that the legal landscape had changed. Pet.4. So petitioners would be entitled, at a minimum, to a new trial.

5. This case is the tip of a very large iceberg. The "fairly novel theory of criminal liability" under which these defendants were convicted, *Stein*, 541 F.3d at 157, was also deployed to destroy a national law firm and to extort hundreds of millions of dollars in fines and onerous deferred prosecution agreements from the major accounting firms—which, in the immediate shadow of what happened to Arthur Andersen, knew they could never survive an indictment regardless of the merits.

The tax bar and popular press recognized immediately that this prosecution was unprecedented and overreaching. Pet.4, 21-22. Like the Andersen prosecution, it was built on a highly aggressive legal theory that criminalized conduct that was widely understood to be lawful professional practice at the time. "These cases have contributed to a seismic shift in the nature of tax practice by deterring lawyers and law firms from providing opinions for legitimate tax planning purposes." Charles A. Rose, *The Tax Lawyer's Dilemma: Recent Developments Heighten Tax Lawyer Responsibilities And Liabilities*, 2011 Colum. Bus. L. Rev. 258, 262 (2011); *see id.* at 289 ("The lack of clarity under the current legal regime, coupled with the fear of punishment, has had a significant detrimental impact on legitimate tax planning service, and has driven talented lawyers away from legitimate tax advisory services."). Lawyers often have an ethical *duty* to pursue their clients' interests within the

bounds of an objectively reasonable understanding of the law, even if the lawyer subjectively believes that the client's interpretation should be rejected. Pet.32-33. So the government's theory is a recipe for incarcerating the entire bar, as well as any citizen with the temerity to challenge the government's position on a debatable point of law.

The U.S. Attorney's Office for the Southern District of New York continues to pursue these prosecutions aggressively. Just in the past few months, it obtained the conviction of the former head of the tax practice at Jenkins & Gilchrist and extracted a deferred prosecution agreement and $554 million fine from one of the banks involved in these transactions. More broadly, federal prosecutors continue to try to fill perceived vacuums in financial and professional regulation with creative expansions of the criminal law. The Second Circuit's holding that criminally "willful" behavior can be found even when the law is objectively ambiguous facilitates that disturbing trend. It turns the rule of lenity on its head and is inconsistent with the most fundamental values of the criminal law. Conflict among the circuits should not be left unresolved on such an important issue, which establishes the line between criminal and lawful professional behavior.

CONCLUSION

The petition should be granted.

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